



## Second Quarter 2012

### Content

---

#### Investment Strategy

Macro Economic Analysis

Interest Rates Strategy

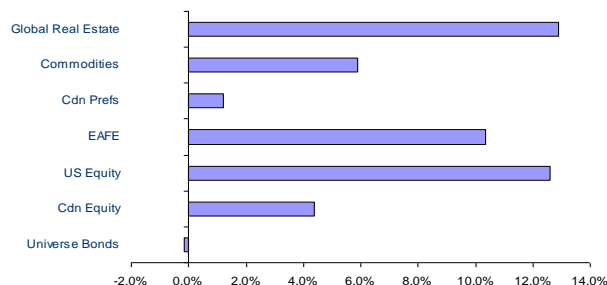
Credit Market Strategy

Equity Market Strategy

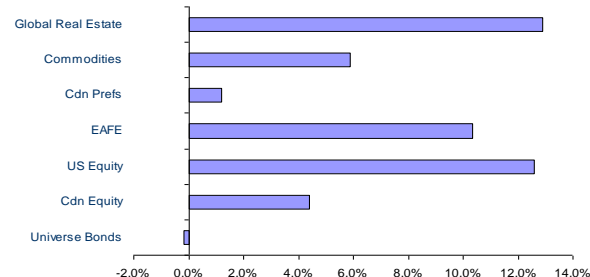
## Asset Allocation

### Asset Class Returns As of Mar 31, 2012

Asset Class Returns QTD



Asset Class Returns YTD



(Source: Bloomberg, GSCI Commodity Index, S&PTSX Preferred Share Index, MSCI EAFE Index, S&P500 Index, S&PTSX Composite Index, Merrill Lynch Canada Bond Index)

### Summary of Our Asset Class Viewpoints

#### Bond Markets

- Central banks around the globe will still administer supportive policies as the recovery remains uncertain and the risks in Europe persist. The Bank of Canada is uncomfortable with the low level of rates and the effect on domestic personal leverage ratios.
- Bond yields remain expensive, and will continue to do so as long as a credible solution to the Euro crisis remains unidentified. Improvements in U.S. economic data could encourage rates higher in the short term, but the extent of the rise will be tempered by the ongoing uncertainty in the risk environment and the path of the recovery.
- Our monitors of credit trends showed that conditions for corporate fundamentals continued to improve. Corporate credit spreads continue to offer attractive value relative to the strength of company balance sheets.

#### Developed Equity Markets

- As we noted in our last strategy, this quarter's earnings forecasts were subject to significant downward revisions to expectations. As such, the year over year earnings growth is expected to only register 6.4%, continuing the decelerating momentum we have been observing since the second quarter of 2011.
- We remain cautious on equities until more attractive valuations emerge, or observe stronger indications supporting the potential for current earnings estimates to come to fruition.

#### Global Real Estate

- Real estate and related investments have shown lower volatility than equity values in the near term, with low vacancy rates in sectors such as apartment properties. Income yields continue to remain attractive versus other fixed investment alternatives.

### Equitable Asset Management's Asset Class Positioning Biases

Asset Class	Benchmark Relative Weight*	Previous Weight
Cash	Neutral	Overweight
Fixed Income	Neutral	Neutral
Duration	Neutral	Neutral
Credit	Neutral	Neutral
Equities	Underweight	Underweight
Canada	Neutral	Underweight
US	Underweight	Underweight
International (Europe / Asia)	Underweight	Underweight
Global Real Estate	Neutral	Neutral
Other Asset Classes	Overweight	No Allocation

\*The stated positioning biases are relative to the benchmark allocation of the Active Balanced ETF Fund.

## Macro Economic Analysis Global Perspectives

John Stilo, CFA  
Director, Portfolio Management

### Critical Themes and Drivers

The passing of the first quarter took with it the grave concerns of a disorderly default by Greece and the possibility of a European Union breakup. What is left in its wake is a region (which represents approximately one quarter of the world's GDP) facing a recession, coupled with significant government austerity requirements, political discord and numerous structural deficiencies in their economies which will require mending. The elimination of near term concerns of a resulting systemic banking crisis, courtesy of a massive liquidity injection by the European Central Bank, served to restore market confidence and propelled certain asset classes past their highs of a year earlier. As we continue to note, as much as asset markets react with a euphoric response to liquidity, these solutions do little to address the underlying solvency issues and structural impairments which still present challenges to the long term fundamentals of the real economy.

### European Debt Crisis – The Squeaky Wheel Gets the Greece

Greece received approval for the €130 billion bailout package along with a generous debt restructuring that forced €197 billion of domestic law bondholders to accept a 53.5% loss on their holdings. The measures are anticipated to move the country closer to the 2020 debt to GDP target of just over 120%. With low growth and high borrowing rates, it appears unlikely that this objective can be achieved and there are already concerns that an additional restructuring may be required. Markets have quickly shifted focus to Spain as it recently identified its 2012 deficit to be much higher at 5.8% of GDP versus 4.4% previously promised to the EU group. Meeting these targets will require approximately €45 billion in spending cuts in an environment where the country is already shrinking. Spain's economic restructuring will involve a righting of the disproportionate share of the construction and real estate sectors as a percentage of the overall economy. The high concentration of economic activity generated by these sectors created excesses on many fronts including leverage, employment and real estate prices.

### China's Economic Landing – A Feather, or a BRIC?

Basic indicators of electricity consumption, steel consumption, and slowing vehicle sales have all been pointing to a downturn in domestic activity also confirmed by the decline in national PMI indices slipping into contraction territory and further supported by the government's own downgrade of their growth forecast to 7.5%. The ongoing slowdown in developed economies, particularly Europe which accounts for 20% of China's trade, is weighing on export growth and making the prospect for higher growth levels less promising. Banking system issues related to rising non-performing loans to local governments and the risk of declining property prices threaten banks' capital and their lending capability which would also challenge future growth.

### Global Growth – The Makings of a Two Speed World

Depending upon the lens being looked through, there exist many diverging opinions on the state of global growth at this juncture in the recovery. Economic data delivered over the past several months has painted a picture of the U.S. economy on the recovery path while most other developed nations lag behind. Encouragingly, measures such as retail sales and metrics highlighting personal consumption in the U.S. have demonstrated a solid advance since the start of the year. U.S. national and regional measures of business confidence and activity have also improved. However, this set of factors is in contrast to the performance of global measures where the trend coming from Europe and Asia has seen business confidence continue to fall. Additional elements contributing to a more positive U.S. profile are job growth and early signs of renewed credit expansion. Again, this contrasts to the situation in Europe where unemployment continues to rise and credit extension has stopped as the banking system looks to mend its capital base. Recent U.S. data has been interpreted as suggesting a decoupling is underway. Against the backdrop of further issues in Europe, slower growth in China and upcoming fiscal reforms, it is unlikely a divergence is sustainable for an extended period unless household credit growth resumes in size or another substitute for the declines in real wage growth emerges.

## Interest Rates Strategy

John Stilo, CFA  
Director, Portfolio Management

### Strategic Positioning Bias

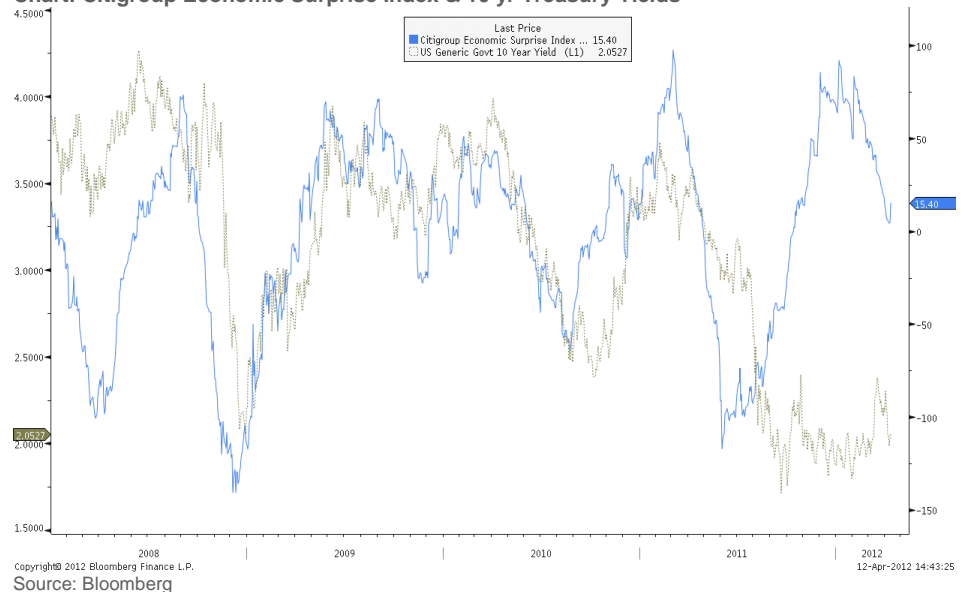
Benchmark relative weighting  
Relative duration position

**NEUTRAL**  
**NEUTRAL**

### Strategic Viewpoints

- Interest rates continue to be shunted by developing economic fundamentals and the ongoing debate over the health of the economy remains at the forefront of discussions. Economic data improvements have lost momentum recently, and April's weak non-farm payroll report is renewing concerns about the sustainability of the U.S. recovery. The current divergence in the U.S. Economic Surprise Index and the level of the U.S. 10yr remains near its widest levels suggesting that the bond market remains priced for factors other than economic fundamentals. This can largely be attributed to Euro sovereign risks and quantitative easing expectations.

Chart: Citigroup Economic Surprise Index & 10 yr Treasury Yields



- The issue of quantitative easing remains a hot topic of debate. The situation appears to be such that current conditions are not supportive of the Federal Reserve administering another round of easing. With inflation expectations high enough to dismiss deflation concerns, risk asset prices remaining at high levels, and the pattern of economic data in the U.S. generally improving, there appears to be little to motivate the Fed at this point. While additional efforts may not be imminent, the program has not been discontinued and the Fed remains prepared to employ it as a tool if necessary. As long as the uncertainty in growth potential and the risks in Europe remain, even the possibility of further QE actions will support some bid to bonds
- In the absence of a definitive withdrawal of unconventional policy measures, or a credible solution to the Euro crisis, the observed factors foster an environment where bond yields are likely to remain at low levels. With downside risks still present from Europe and potential disruptions in the path of the economic recovery, maintaining a near neutral allocation remains appropriate.
- Without major disruptions on the risk front, moderate improvements in economic data will likely encourage yields modestly higher, but the extent of the rise will be tempered by the ongoing uncertainty in the risk environment and the path of the recovery.

# Credit Market Strategy

Dan Lavric, CFA  
Portfolio Manager, Credit

## Strategic Positioning Bias

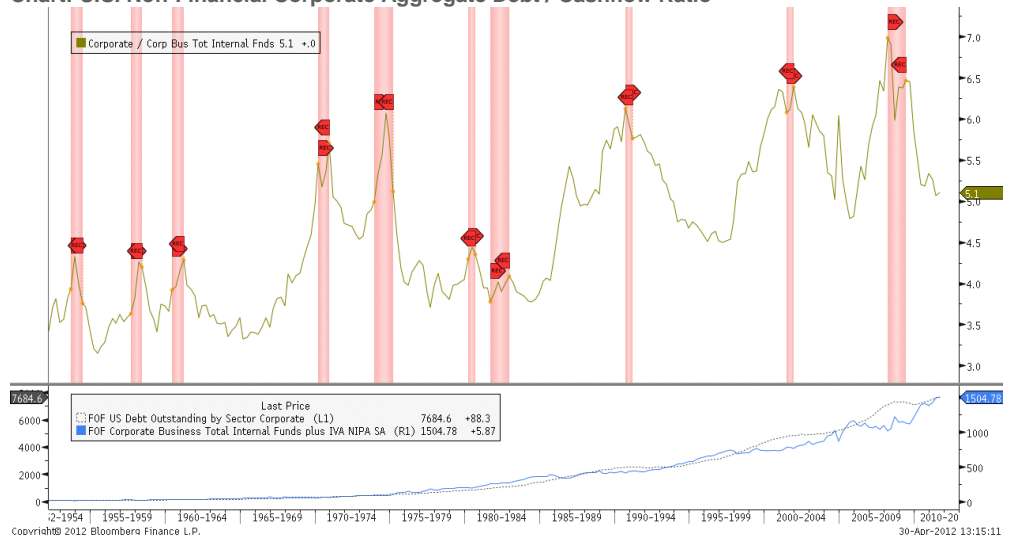
Benchmark relative weighting

**NEUTRAL**

## Strategic Viewpoints

- Our monitors of credit trends showed that conditions for corporate fundamentals continued to improve. Components that improved were related to easing tensions in the European financial system as the significant liquidity efforts of global central banks eased pressure on global credit markets. Measures of corporate health including interest coverage, liquidity, and the ability to service debt all reside near their highs.
- As the accompanying chart demonstrates, the aggregate level of debt to total cash flow for U.S. non-financial corporations is just over 5 times and is well off the cycle highs that would generate concerns of high leverage and an ensuing period of high defaults. In fact, investment grade credit spreads still reside at levels that would be consistent with higher leverage, consistent with our belief that corporate credit spreads continue to offer value relative to the strength of company balance sheets.

Chart: U.S. Non-Financial Corporate Aggregate Debt / Cashflow Ratio



Source: Bloomberg, NIPA, Fed Flow of Funds, Equitable Life

- In Canada, lower new issuance volumes have helped to keep corporate bond yields secured at lower levels. Compared to the U.S. experience where both investment grade and high yield bond new issuance has been high, Canada is running at two thirds of volume seen in the same period of 2011. We expect both retail and institutional interest in the corporate bond market to remain strong for the coming quarters as inflows into corporate bond mutual funds and related exchange traded funds (ETFs) continue to be healthy.
- The major risks for the remainder of the year are political risks, possible erosion in market sentiment, and a deeper recession in Europe as a result of larger fiscal austerities. While the impact of these possible developments could be strong enough to cause credit spreads to widen on market concern, it will not be strong enough to lead to a fundamental deterioration of credit metrics during 2012.

# Equity Market Strategy

John Stilo, CFA  
Dan Lavric, CFA

## Strategic Positioning Bias

Benchmark relative weighting

**UNDERWEIGHT**

Regional weightings

Canada

**NEUTRAL**

U.S.

**UNDERWEIGHT**

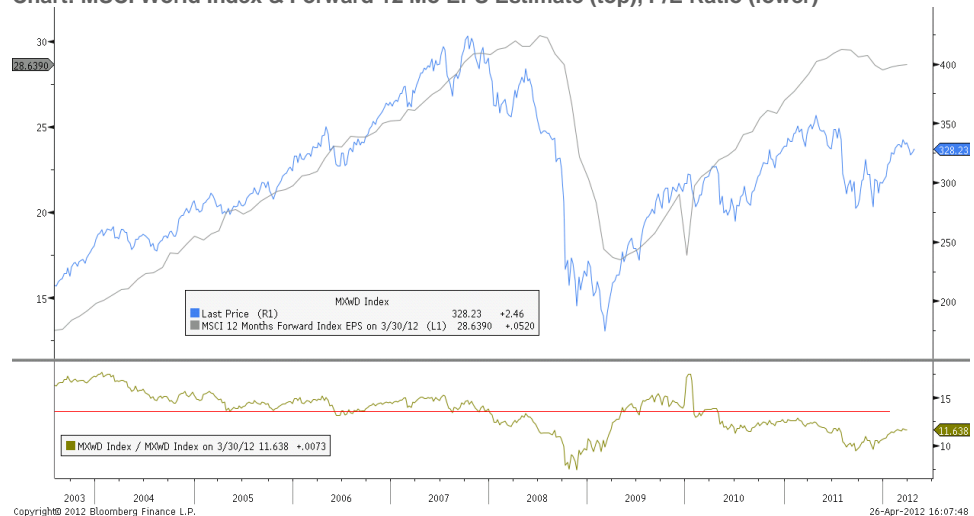
International

**UNDERWEIGHT**

## Strategic Viewpoints

- Given the backdrop of weaker fundamentals, we continue to have a less constructive view on equities than the general consensus currently appears to hold. As discussed in our Macro Economic Analysis, there are significant headwinds to global growth and the risks surrounding the European sovereign crisis remain a material threat to market sentiment and the stability of the recovery.
- A key theme in recent equity market performance has been P/E multiple expansion. Where Q4 marked a significant compression in the multiple, Q1 witnessed a strong reversal based on improved sentiment but only marginal earnings improvements. Our view is that multiples should be reflective of the uncertainty of earnings growth, and the current environment is fraught with potentially negative implications for growth suggesting that the uncertainty factor is high and thus multiples should reside at below average levels to compensate for the additional risk.

Chart: MSCI World Index & Forward 12 Mo EPS Estimate (top), P/E Ratio (lower)



Source: Bloomberg

- Currently, analysts estimate S&P 500 earnings growth at \$24.00 per share in Q1 2012. As we noted in our last strategy this quarter was subject to significant downward revisions to expectations. As such, the year over year earnings growth is expected to only register 6.4%, continuing the decelerating momentum we have been observing since the second quarter of 2011. Analysts are only expecting 6 of the 10 sectors in the S&P 500 Index to report positive growth for first quarter earnings.
- Policy action from global central banks and governments has provided critical support to equity markets and other risk asset classes over the past three years. We are cautious of the implications of a withdrawal of unconventional stimulus such that risk assets could underperform as investors remain unsure of the ability of the global economy to sustain itself without the helping hand of policy. The global political landscape is also undergoing changes as elections throughout Europe and the U.S. could introduce regime changes with leadership that has less of an appetite for past approaches and programs that were market supportive but fiscally unfriendly.

This information does not constitute investment, legal, accounting, tax or other professional advice. Readers are advised to seek professional advice.

® denotes a trademark of The Equitable Life Insurance Company of Canada.

Any statements contained herein that are not based on historical fact are forward-looking statements. Any forward-looking statements represent the portfolio manager's best judgment as of the present date as to what may occur in the future. However, forward-looking statements are subject to many risks, uncertainties and assumptions, and are based on the portfolio manager's present opinions and views. For this reason, the actual outcome of the events or results predicted may differ materially from what is expressed. Furthermore, the portfolio manager's views, opinions or assumptions may subsequently change based on previously unknown information, or for other reasons. Equitable Life of Canada assumes no obligation to update any forward-looking information contained herein. The reader is cautioned to consider these and other factors carefully and not to place undue reliance on forward-looking statements.

© The Equitable Life Insurance Company of Canada. Reproduction of this publication without written permission is prohibited. All Rights Reserved.